

**COMMONWEALTH OF MASSACHUSETTS**

**DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

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Boston Gas Company d/b/a )  
KeySpan Energy Delivery New England )

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D.T.E. 02-37

**REPLY COMMENTS OF BOSTON GAS COMPANY  
D/B/A KEYSpan ENERGY DELIVERY NEW ENGLAND**

**I. INTRODUCTION**

On June 7, 2002, the Department of Telecommunications and Energy (“Department”) issued a notice soliciting comments on the proposal by Boston Gas Company d/b/a KeySpan Energy Delivery New England (“KeySpan” or “Company”) to extend for a one-year period the performance-based ratemaking plan (“PBR Plan”) established for the Company in Boston Gas Company, D.P.U. 96-50 (Phase I) (1996). On June 24, 2002, the Attorney General filed comments asking the Department to deny the Company’s proposal (“Attorney General Comments”).<sup>1</sup> For the reasons stated herein, the Department should reject the claims of the Attorney General and allow a one-year extension of the PBR Plan, as requested by the Company.

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<sup>1</sup> Although the Division of Energy Resources (“DOER”) intervened in this proceeding at the public hearing conducted by the Department on June 26, 2002, DOER did not submit written comments on the Company’s proposal. Nor were comments filed by any interested person other than the Attorney General. To the extent that DOER’s statements at the hearing may constitute comment on the Company’s proposal, the Company has addressed those issues in this response.

On March 27, 2002, the Company notified the Department of its intention to file a base-rate and PBR proposal to succeed the PBR Plan approved by the Department in D.P.U. 96-50. The Company noted that the base-rate filing would likely encompass both the establishment of new cast-off rates, using a traditional cost-of-service ratemaking approach, and a proposal to modify or extend the PBR Plan established in D.P.U. 96-50. On May 21, 2002, the Company notified the Department that it had decided to delay the filing of a comprehensive base-rate proposal and, for the interim period, requested a one-year extension of the PBR Plan.

In opposing the Company's request for a one-year extension of the PBR Plan, the Attorney General makes two unsubstantiated claims: (1) a "required evaluation" to continue the existing PBR plan for a one-year period has not occurred and that the "Company has requested that this evaluation not occur until 2003" (Attorney General Comments at 2); and (2) there is "no evidentiary or legal basis to increase rates," and therefore, a one-year extension of the PBR Plan would require a full-scale cost of service investigation by the Department, and without such an investigation, the PBR Plan must be terminated (id. at 2-3).<sup>2</sup> As discussed below, the Attorney General's arguments are without merit.

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<sup>2</sup> Implicitly, the Attorney General is asking the Department to impose a requirement that no change or extension of the PBR Plan can occur outside the context of a base-rate proceeding. In moving to a PBR framework, the Department has imposed no such requirement.

## **II. DISCUSSION**

### **A. It Is Within the Department's Discretion to Approve a One-Year Extension of the PBR Plan**

The Company requested that the Department extend the existing PBR Plan for a one-year period to maintain continuity within the PBR framework while the Company prepares a comprehensive base-rate and PBR proposal to be filed next year. In response, the Attorney General claims that:

The Department has clearly indicated that it would conduct an evaluation of the expired PBR before making a decision concerning modification and “depending upon the results of this evaluation, the plan may be extended without modification for an additional term, extended with modifications, or terminated.” The required evaluation has not occurred and the Company has requested that this evaluation not occur until 2003.<sup>3</sup>

(Attorney General Comments at 2, quoting D.P.U. 96-50, at 320).

The Attorney General's claim that “the Department has clearly indicated that it would conduct an evaluation of the expired PBR before making a decision concerning modification” is a misrepresentation and overstatement of the Department's comments in D.P.U. 96-50 and of the applicability of those comments to the Company's limited request. Whereas the Attorney General frames the issue as whether the “required evaluation” has occurred in relation to the extension or modification of the PBR Plan, to the extent that an evaluation is required, the evaluation must apply equally to the modification or termination alternative. There is no support for the Attorney General's

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<sup>3</sup> The Attorney General's statement that the Company has requested the “required evaluation” not occur until 2003 is a misrepresentation of the Company's position in this proceeding. As discussed below, the Company is not requesting that the “required evaluation” be postponed until 2003, but rather the Company is suggesting that the nature and scope of the evaluation may be limited where the PBR Plan is extended without modification for one year, and does not involve a change in the cast-off rates or a change to the price-cap formula.

assertion that, without a certain level of evaluation, the default option is termination of the plan.

The Department's regulatory goals in moving to a PBR framework are well established. The Department has stated that the primary objective of incentive regulation is to provide marketplace benefits to consumers, promoting more efficient utility operations, cost control, and opportunities for reduced electric and gas rates. Incentive Regulation, D.P.U. 94-158, at 40 (1995); D.P.U. 96-50, at 318. The Department has consistently stated that "well-designed incentive mechanisms provide utilities with greater incentives to reduce costs than exist under traditional COS/ROR regulation." Incentive Regulation at 55. And the Department has stated that incentive mechanisms should provide a more efficient regulatory approach that enables the Department to avoid burdensome, complicated and time-consuming reviews of company management. Id. at 64-65; D.P.U. 96-50 at 320.

In D.P.U. 96-50, the Department explained that:

[O]ne potential benefit of incentive regulation is a reduction in regulatory and administrative costs. Additionally, the Department has found that a well-designed price-cap mechanism should be of sufficient duration to give the plan enough time to achieve its goals, and to provide utilities with the appropriate economic incentives and certainty to follow through with medium and long-term strategic business decisions.

D.P.U. 96-50, at 320 (citations omitted). And further, the Department found that:

[T]he Company's proposed five-year term will provide a sufficient period to evaluate administrative efficiencies and to allow Boston Gas the level of certainty required to enter into business decisionmaking.

Id. Therefore, to the extent that an evaluation is “required” prior to a long-term extension, modification or termination, the Department has indicated that the focus of such an evaluation would be on the success of the PBR Plan in achieving the Department’s regulatory objectives. Beyond this reference, the Department’s statements in D.P.U. 96-50 did not in any way prescribe or preordain the nature or scope of any evaluation that would be undertaken by the Company in the context of a proposal such as it has now made, a limited, short-term extension of the PBR Plan.

Although the Department’s order in D.P.U. 96-50 is not precise in terms of the evaluation that would be undertaken to determine the appropriate sequel to the PBR Plan, the Company recognizes that a long-term (five-year) extension or modification of the PBR Plan could trigger a review of the Company’s cost of service or an updating of the productivity data serving as the basis of the price-cap formula (Attorney General Comments at 2 n.4, citing Testimony of Dr. Lowry).<sup>4</sup> To that end, the Company has consistently stated that it anticipates that any proposal to increase base rates and to modify the price-cap formula for an extended time period may require a comprehensive investigation and evaluation by the Department using cost-of-service ratemaking

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<sup>4</sup> The Attorney General’s reference to the testimony of Dr. Lowry in D.P.U. 96-50 is misleading. Dr. Lowry was not estimating the length of time that his productivity values would be valid, but rather, Dr. Lowry was stating that, if after the five-year plan, he was asked to evaluate another “conventional” PBR plan, he would envision taking a second look at the available information and the trend of the total factor productivity to capture any unforeseen productivity growth or lack thereof. However, the fact that the Company’s earnings have declined over the period of the PBR Plan tends to indicate not only that “unforeseen productivity growth” has not occurred, but that the productivity factor established in D.P.U. 96-50 may be too high. Therefore, additional analysis of this factor is not likely to produce an outcome different from that already incorporated in the existing price-cap formula. This is consistent with the Department’s determination that, if Berkshire were to conduct an independent productivity study, the likely result would be similar to the zero percent productivity factor proposed by the company in that proceeding. The Berkshire Gas Company, D.T.E. 01-56, at 21 (2002); see also D.T.E. 01-56-A at 8.

principles, as suggested by the Attorney General. (See May 21, 2002 and March 27, 2002 Letters from KeySpan to the Commission).

With respect to the Company's proposal for a short-term extension of the PBR Plan, there is sufficient information already before the Department to evaluate whether the PBR Plan has succeeded in achieving the Department's regulatory goals, including administrative efficiency. In that regard, the extension of the PBR Plan for a one-year period without modification is consistent with the Department's regulatory objectives in establishing the PBR Plan, and therefore, is consistent with the public interest. The basis for this extension is three-fold: (1) the Company is not over-earning under PBR, and in fact, is operating at a net loss so that the application of the price-cap formula will maintain the appropriate incentives for the Company to manage its costs; (2) the Company continues to be subject to the service-quality requirements and associated penalty provisions; and (3) the Department has recently approved a similar price-cap formula for an extended time period in The Berkshire Gas Company, D.T.E. 01-56 (2002), which reaffirmed the continuing applicability of the productivity study set forth by the Company in D.P.U. 96-50.

With respect to earnings and the incentive to manage costs, the Company has filed an annual earnings and return on equity calculation in each year of the PBR Plan.<sup>5</sup> These calculations show that the Company's return on equity has declined over the five-year period, which has put significant pressure on the Company to manage costs. In Appendix B, the Company has calculated its earnings and return on equity for the year ending

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<sup>5</sup> These calculations are provided as Appendix A, as is the Company's response to Information Request AG 1-2 from D.T.E. 01-74. Pursuant to 220 C.M.R. § 1.10(3), the Company requests that the Department incorporate by reference these calculations.

December 31, 2001, which indicates that the Company is operating at a net loss of approximately \$10 million per year.<sup>6</sup> Despite this operating loss, the Company has elected to delay the filing of a base-rate case until 2003. This delay benefits customers and reduces administrative costs for the Department and other parties who would participate in the rate proceeding.

Second, in accordance with the terms of the PBR Plan approved in D.P.U. 96-50, the Company has implemented a comprehensive service-quality program and has reported its results to the Department each year. The Department recently approved the Company's proposal to continue monitoring and reporting service-quality results to the Department consistent with the service-quality guidelines established in Service Quality Standard for Electric Distribution Companies and Local Gas Distribution Companies, D.T.E. 99-84 (2001). Although the Department's authority to penalize the Company for service-quality deficiencies stems from G.L. c. 164, § 1E, and therefore, would not be applicable to the Company in the absence of a PBR Plan, the Company has submitted a service-quality plan to the Department that would subject the Company to service-quality penalties in lieu of that authority. Extension of the PBR Plan will have the effect of supporting the Department's jurisdiction in relation to service-quality penalties.<sup>7</sup>

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<sup>6</sup> Appendix B consists of the affidavit of Dennis W. Carroll, Vice President and Controller, which demonstrates that, in 2001: (i) the Company has a net operating loss of \$30.2 million and a return on equity of negative 7.69% by applying the earnings test under the PBR formula; and (ii) the Company had a net operating loss of \$10.7 million and a return on equity of negative 2.73% with the exclusion of the costs associated with the annual amortization of the acquisition premium associated with the merger of Eastern Enterprises with KeySpan Corporation. The calculations set forth in Appendix B are based exclusively on information submitted to the Department in the Company's 2000 and 2001 Annual Reports to the Department. The pages cited in the affidavit are from the Company's 2001 and 2000 Annual Returns and are attached as Appendix C.

<sup>7</sup> See Letter Order Approving Gas Distribution Companies SQ Plans at 5 (April 17, 2002) stating that: "with respect to Blackstone and Fitchburg Gas division, the Department notes that they are

(footnote continued)

Third, the continued viability of the productivity study underlying the Company's price-cap formula was recently affirmed by the Department in approving a long-term price-cap formula for The Berkshire Gas Company. The Berkshire Gas Company, D.T.E. 01-56, at 21 (2002); see also D.T.E. 01-56-A at 7-8. Thus, an "update" to the productivity study is not necessary for the extension of the PBR Plan for a one-year period and would likely yield results similar to what is already encompassed in the price-cap formula. See D.T.E. 01-56, at 21.

Accordingly, the Department has before it ample information with which to perform an evaluation as to the appropriateness of extending the PBR Plan for a one-year period. The Company is not proposing to change the cost-of-service rates or to implement a long-term extension or modification of the price-cap formula, and the extension of the PBR plan without modification serves the same objectives that the Department identified in implementing the plan at its inception. In fact, of the three alternatives identified by the Department in D.P.U. 96-50, it would be reasonable for the Department to require less information in extending the PBR without modification than it would to extend it with modification or to terminate it. The extension of the PBR Plan fully comports with the Department's expectation that PBR will provide utilities with better incentives to reduce costs than traditional cost-of-service ratemaking and will obviate the need for frequent base-rate proceedings.

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(footnote continued)

not operating under a PBR nor have they come before us seeking approval of a merger-related rate plan. Therefore, the penalty provisions of their SQ plan are not in effect as yet."



**B. It Is Within the Department’s Discretion to Determine the Nature and Scope of Any Proceeding to Extend the PBR Plan For One Year Without Modification**

It is well established that the Department has broad authority to determine ratemaking matters in the public interest. See e.g., Boston Gas Co. v. Dept. of Telecommunications and Energy, 436 Mass. 233 (2002). Under G.L. c. 164, § 94, the Department is responsible for ensuring the “propriety” of proposed rates, which the Department has stated, in practice is interpreted to mean that rates are “just and reasonable.” Incentive Regulation, at 42. The Department has noted that the statute does not prescribe a particular method by which the Department must fulfill its statutory mandate of setting just and reasonable rates. Id. The Department has also noted that it has been its practice, over many decades in the regulation of gas and electric utilities, to construe its authority so as to allow the adoption of alternative methods of regulation in response to changing market circumstances and consumer needs and to meets its regulatory objectives.<sup>8</sup> Id.

Similarly, G.L. c. 30A, § 11, which is referenced by the Attorney General, applies only “where the legal rights, duties or privileges of a specifically named person are required by constitutional right or by any provision of the General Laws to be determined after opportunity for an agency hearing” (emphasis added). In the absence of a specific constitutional or statutory requirement for a hearing, the Department is free to identify the nature and scope of proceedings and matters brought before it. Accordingly, in this

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<sup>8</sup> In addition, G.L. c. 164, § 1E grants the Department the authority to promulgate rules and regulations relating to the establishment of performance-based ratemaking plans for utilities. As a result, this provision provides the Department with the inherent authority to render determinations as to the standards and process of determining whether a PBR Plan should be extended for a limited duration.

proceeding, it is well within the Department's discretion to consider a request to extend the existing PBR Plan, which has been approved by the Department and reviewed by the Supreme Judicial Court.

The Attorney General argues that the Company has not presented any "evidentiary or legal basis" to increase rates and that the filing of a Sixth Annual Compliance filing would require a cost-of-service investigation under G.L. c. 164, § 94 (Attorney General Comments at 2-3).<sup>9</sup> However, in structuring the PBR Plan pursuant to its plenary jurisdiction, the Department established a framework whereby a cost-of-service investigation is undertaken to set cast-off rates, that are adjusted annually on a going-forward basis pursuant to a price-cap formula. The design and operation of the price-cap formula is the result of a fully-litigated proceeding conducted pursuant to G.L. c. 164, § 94, as are the cast-off rates. The extension of the PBR Plan for a one-year period without modification falls squarely within that framework, and therefore, would require only the process afforded other compliance filings submitted to the Department during the term of the PBR Plan, which did not include cost-of-service investigations or even evidentiary hearings. Like all other compliance filings submitted pursuant to the PBR Plan, the Company will provide information necessary for the Department to evaluate whether it has accurately applied the price-cap formula and calculated new rates

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<sup>9</sup> In attempting to justify the claim that the PBR Plan cannot be extended without a full-scale cost of service investigation by the Department, the Attorney General refers to the Department's statements in D.P.U. 96-50 that "it is premature for the Company to assume that its PBR plan will be merely extended for another term, in the same form and substance as approved herein . . . ." (Attorney General Comments at 2 n.2) and that "given the relative lack of experience with PBRs in the gas distribution industry, it would be speculative to presume what modifications, if any, a PBR approved in 1996 would require in the year 2001" (*id.* at n. 5). However, these statements only underscore the point that the Department did not predetermine in D.P.U. 96-50 the requirements for extending the PBR Plan, or for implementing a ratemaking plan to succeed the PBR Plan.

in order to make a determination that the proposed rates are just and reasonable. As in all prior years, the Attorney General will have the opportunity to participate in that proceeding and to comment on the Company's application of the formula and the rates derived therefrom.

The Attorney General also claims that [t]here is no evidence in this record to support the Company's claim that it has a "substantial revenue deficiency." However, there is no requirement that the Company make such a showing in order for the Department to approve an extension of the PBR Plan, nor is a revenue deficiency a prerequisite of any rate increase that would arise from a compliance filing through the application of the price-cap formula. This is because the design and intent of the price-cap formula is targeted to prices and not to the Company's cost of service. See D.P.U. 96-50, at 259 (stating that the "primary component of [the Boston Gas] PBR proposal is a price cap plan that would apply to the rates of monopoly services"). Nonetheless, the Company has filed, as Appendix B, a calculation of its return on equity, that shows a net loss for calendar year 2001.<sup>10</sup>

In fact, the PBR Plan approved by the Department in D.P.U. 96-50 was adopted after proper notice, lengthy hearings, and briefing in which the Attorney General fully and actively participated. In its order, the Department allowed for the extension of the PBR Plan and, absent a constitutional or statutory requirement to the contrary, it is within the Department's discretion to determine the process that is necessary to reach a determination as to the Company's proposal. To the extent that "due process" requires

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<sup>10</sup> Although the calculation is made using publicly available information, if the Department believes is would be helpful, the Company is prepared to respond to additional questions either in written discovery or orally in a hearing.

notice and a hearing, the Department has provided that opportunity in this proceeding.<sup>11</sup> Therefore, based on the record established in this proceeding and available to the Department as a matter of administrative notice, the Department may extend the PBR for a year based on the conditions that (i) any rate adjustment outside of the PBR formula will be deferred for another year, and (ii) SQI measures and penalties will apply coincident with the PBR Plan.<sup>12</sup>

### III. CONCLUSION

The Department has an ample basis to grant the Company's limited request to extend the existing, approved PBR Plan for an additional year, to permit sufficient time for the Company to complete the development of a significant rate-consolidation proposal that it intends to file for Department consideration in conjunction with a more comprehensive review of the PBR Plan. Over five years of experience and data filed herewith demonstrates that the continuation of the PBR Plan for an additional year will not result in windfall profits or rates that are inappropriately high. Therefore, for all the reasons set forth in these reply comments, the Attorney General's opposition to the

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<sup>11</sup> In arguing that the absence of hearings would raise due process issues, the Attorney General cites generally to G.L. c. 30A, § 11 and 220 C.M.R. §§ 1.00 et seq. (Attorney General Comments at 3 n.6). As stated above, G.L. c. 30A, § 11 applies only to adjudicatory hearings, as defined in G.L. c. 30A, § 1, which is not implicated in this proceeding. In addition, the reference by the Attorney General to the Administrative Procedure Act and Department's own regulations provides no indication of specific administrative requirements that have not been addressed in this proceeding. For example, there is nothing in these authorities that requires the Department to conduct a hearing procedure in excess of that provided by the Department in this proceeding, nor does the Attorney General attempt to cite to any specific provision in support of that proposition.

<sup>12</sup> The Attorney General's reference to the Department's investigation into the termination of the Verizon price-cap plan (Attorney General Comments at 2 n.2) is also misplaced. In D.T.E. 01-31, Verizon proposed termination of the price-cap plan, previously in effect, and its replacement with an entirely new pricing paradigm that does not involve a price-cap index. Notably, the Department did not perform a cost-of-service investigation in reviewing Verizon's proposal.

Company's proposal should be dismissed, and the Department should approve the Company's proposal to continue its PBR Plan for an additional year.

Respectfully submitted,

**Boston Gas Company  
d/b/a KeySpan Energy Delivery  
New England**

By its attorneys,

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Robert J. Keegan  
Cheryl M. Kimball  
Keegan, Werlin & Pabian, LLP  
21 Custom House Street  
Boston, MA 02108  
(617) 951-1400

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Richard A. Visconti, General Counsel  
Patricia Crowe, Regulatory Attorney  
Boston Gas Company  
d/b/a KeySpan Energy Delivery New England  
One Beacon Street  
Boston, MA 02108  
(617) 723-5512

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